

(ii) On December 31, 1997, D is admitted as a partner to the partnership in exchange for \$10,000 cash.

(iii) On January 5, 2000, Property A is distributed to D in complete liquidation of D's interest in the partnership.

(iv) The distribution of Property A to D occurred more than five years after the contribution of the property to the partnership. On these facts, however, a principal purpose of the transaction was to minimize the period of time that A would have to remain partners with a potential acquirer of Property A, and treating the five-year period of section 704(c)(1)(B) as running during a time when Property A was still effectively owned through the partnership by members of the contributing affiliated group of which A is a member is inconsistent with the purpose of section 704(c)(1)(B). Prior to the admission of D as a partner, the pooling of assets between A and B, on the one hand, and C, on the other hand, although sufficient to constitute ABC as a valid partnership for federal income tax purposes, is not a sufficient pooling of assets for purposes of running the five-year period with respect to the distribution of Property A to D. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this *Example 2* would have the effect of substantially nullifying the five-year requirement of section 704(c)(1)(B) and this section and elevating the form of the transaction over its substance. As a result, with respect to the distribution of Property A to D, the five-year period of section 704(c)(1)(B) is tolled until the admission of D as a partner on December 31, 1997. Therefore, the distribution of Property A occurred before the end of the five-year period of section 704(c)(1)(B), and A recognizes gain of \$9,000 under section 704(c)(1)(B) on the distribution.

(g) *Effective date.* This section applies to distributions by a partnership to a partner on or after January 9, 1995.

[T.D. 8642, 60 FR 66730, Dec. 26, 1995, as amended by T.D. 8717, 62 FR 25500, May 9, 1997]

§ 1.705-1 Determination of basis of partner's interest.

(a) *General rule.* (1) Section 705 and this section provide rules for determining the adjusted basis of a partner's interest in a partnership. A partner is required to determine the adjusted basis of his interest in a partnership only when necessary for the determination of his tax liability or that of any other person. The determination of the adjusted basis of a partnership interest is ordinarily made as of the end of a

partnership taxable year. Thus, for example, such year-end determination is necessary in ascertaining the extent to which a partner's distributive share of partnership losses may be allowed. See section 704(d). However, where there has been a sale or exchange of all or a part of a partnership interest or a liquidation of a partner's entire interest in a partnership, the adjusted basis of the partner's interest should be determined as of the date of sale or exchange or liquidation. The adjusted basis of a partner's interest in a partnership is determined without regard to any amount shown in the partnership books as the partner's "capital", "equity", or similar account. For example, A contributes property with an adjusted basis to him of \$400 (and a value of \$1,000) to a partnership. B contributes \$1,000 cash. While under their agreement each may have a "capital account" in the partnership of \$1,000, the adjusted basis of A's interest is only \$400 and B's interest \$1,000.

(2) The original basis of a partner's interest in a partnership shall be determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests). Such basis shall be increased under section 722 by any further contributions to the partnership and by the sum of the partner's distributive share for the taxable year and prior taxable years of:

(i) Taxable income of the partnership as determined under section 703(a),

(ii) Tax-exempt receipts of the partnership, and

(iii) The excess of the deductions for depletion over the basis of the depletable property, unless the property is an oil or gas property the basis of which has been allocated to partners under section 613A(c)(7)(D).

(3) The basis shall be decreased (but not below zero) by distributions from the partnership as provided in section 733 and by the sum of the partner's distributive share for the taxable year and prior taxable years of:

(i) Partnership losses (including capital losses), and

(ii) Partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures.

(4) The basis shall be decreased (but not below zero) by the amount of the partner's deduction for depletion allowable under section 611 for any partnership oil and gas property to the extent the deduction does not exceed the proportionate share of the adjusted basis of the property allocated to the partner under section 613A(c)(7)(D).

(5) The basis shall be adjusted (but not below zero) to reflect any gain or loss to the partner resulting from a disposition by the partnership of a domestic oil or gas property after December 31, 1974.

(6) For the effect of liabilities in determining the amount of contributions made by a partner to a partnership or the amount of distributions made by a partnership to a partner, see section 752 and § 1.752-1, relating to the treatment of certain liabilities. In determining the basis of a partnership interest on the effective date of subchapter K, chapter 1 of the Code, or any of the sections thereof, the partner's share of partnership liabilities on that date shall be included.

(7) For basis adjustments necessary to coordinate sections 705 and 1032 in certain situations in which a partnership disposes of stock of a corporation that holds a direct or indirect interest in the partnership, see § 1.705-2.

(b) *Alternative rule.* In certain cases, the adjusted basis of a partner's interest in a partnership may be determined by reference to the partner's share of the adjusted basis of partnership property which would be distributable upon termination of the partnership. The alternative rule may be used to determine the adjusted basis of a partner's interest where circumstances are such that the partner cannot practicably apply the general rule set forth in section 705(a) and paragraph (a) of this section, or where, from a consideration of all the facts, it is, in the opinion of the Commissioner, reasonable to conclude that the result produced will not vary substantially from the result obtainable under the general rule. Where the alternative rule is used, adjustments may be necessary in determining the adjusted basis of a partner's interest in a partnership. Adjustments would be required, for example, in order to reflect in a partner's share of

the adjusted basis of partnership property any significant discrepancies arising as a result of contributed property, transfers of partnership interests, or distributions of property to the partners. The operation of the alternative rules may be illustrated by the following examples:

Example 1. The ABC partnership, in which A, B, and C are equal partners, owns various properties with a total adjusted basis of \$1,500 and has earned and retained an additional \$1,500. The total adjusted basis of partnership property is thus \$3,000. Each partner's share in the adjusted basis of partnership property is one-third of this amount, or \$1,000. Under the alternative rule, this amount represents each partner's adjusted basis for his partnership interest.

Example 2. Assume that partner A in example 1 of this paragraph sells his partnership interest to D for \$1,250 at a time when the partnership property with an adjusted basis of \$1,500 had appreciated in value to \$3,000, and when the partnership also had \$750 in cash. The total adjusted basis of all partnership property is \$2,250 and the value of such property is \$3,750. D's basis for his partnership interest is his cost, \$1,250. However, his one-third share of the adjusted basis of partnership property is only \$750. Therefore, for the purposes of the alternative rule, D has an adjustment of \$500 in determining the basis of his interest. This amount represents the difference between the cost of his partnership interest and his share of partnership basis at the time of his purchase. If the partnership subsequently earns and retains an additional \$1,500, its property will have an adjusted basis of \$3,750. D's adjusted basis for his interest under the alternative rule is \$1,750, determined by adding \$500, his basis adjustment to \$1,250 (his one-third share of the \$3,750 adjusted basis of partnership property). If the partnership distributes \$250 to each partner in a current distribution, D's adjusted basis for his interest will be \$1,500 (\$1,000, his one-third share of the remaining basis of partnership property, \$3,000, plus his basis adjustment of \$500).

Example 3. Assume that BCD partnership in example 2 of this paragraph continues to operate. In 1960, D proposes to sell his partnership interest and wishes to evaluate the tax consequences of such sale. It is necessary, therefore, to determine the adjusted basis of his interest in the partnership. Assume further that D cannot determine the adjusted basis of his interest under the general rule. The balance sheet of the BCD partnership is as follows:

Internal Revenue Service, Treasury

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Assets	Adjusted basis per books	Market value
Cash	\$3,000	\$3,000
Receivables	4,000	4,000
Depreciable property	5,000	5,000
Land held for investment	18,000	30,000
Total	30,000	42,000

Liabilities and capital	Per books
Liabilities	\$6,000
Capital accounts:	
B	4,500
C	4,500
D	15,000
Total	30,000

The \$15,000 representing the amount of D's capital account does not reflect the \$500 basis adjustment arising from D's purchase of his interest. See example 2 of this paragraph. The adjusted basis of D's partnership interest determined under the alternative rule is as follows:

D's share of the adjusted basis of partnership property (reduced by the amount of liabilities) at time of proposed sale	\$15,000
D's share of partnership liabilities (under the partnership agreement liabilities are shared equally)	2,000
D's basis adjustment from example 2	500
Adjusted basis of D's interest at the time of proposed sale, as determined under alternative rule	17,500

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8437, 57 FR 43903, Sept. 23, 1992; T.D. 8986, 67 FR 15114, Mar. 29, 2002]

§ 1.705-2 Basis adjustments coordinating sections 705 and 1032.

(a) *Purpose.* This section coordinates the application of sections 705 and 1032 and is intended to prevent inappropriate increases or decreases in the adjusted basis of a corporate partner's interest in a partnership resulting from the partnership's disposition of the corporate partner's stock. The rules under section 705 generally are intended to preserve equality between the adjusted basis of a partner's interest in a partnership (outside basis) and such partner's share of the adjusted basis in partnership assets (inside basis). However, in situations where a section 754 election was not in effect for the year in which a partner acquired its interest, the partner's inside basis and outside basis may not be equal. In these situations, gain or loss allocated to the

partner upon disposition of the partnership assets that is attributable to the difference between the adjusted basis of the partnership assets absent the section 754 election and the adjusted basis of the partnership assets had a section 754 election been in effect generally will result in an adjustment to the basis of the partner's interest in the partnership under section 705(a). Such gain (or loss) therefore generally will be offset by a corresponding decrease in the gain or increase in the loss (or increase in the gain or decrease in the loss) upon the subsequent disposition by the partner of its interest in the partnership. Where such a difference exists with respect to stock of a corporate partner that is held by the partnership, gain or loss from the disposition of corporate partner stock attributable to the difference is not recognized by the corporate partner under section 1032. To adjust the basis of the corporate partner's interest in the partnership for this unrecognized gain or loss would not be appropriate because it would create an opportunity for the recognition of taxable gain or loss on a subsequent disposition of the partnership interest where no economic gain or loss has been incurred by the corporate partner and no corresponding taxable gain or loss had previously been allocated to the corporate partner by the partnership.

(b) *Single partnership.*—(1) *Required adjustments relating to acquisitions of partnership interest.* (i) This paragraph (b)(1) applies in situations where a corporation acquires an interest in a partnership that holds stock in that corporation (or the partnership subsequently acquires stock in that corporation in an exchanged basis transaction), the partnership does not have an election under section 754 in effect for the year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032)